

# Overhead cost management - An easy guide



(Who's minding the store - It's not my problem!)

## 1. The general cost structure

- Manufacturing industry generally recovers the overheads by increasing the direct cost of the products by some factor. In the simplest form the total overhead cost for the company is divided by the total number of available direct labour hours (or machine hours) to give an "overhead rate".
- The overhead rate is multiplied by the number of direct labour hours (or machine hours) required for the individual product to give an overhead allocation.
- The overhead allocation, the cost of direct labour and the cost of direct materials are added up to give the "cost" of the product.

## 2. Overhead costs are rising in relation to other costs.

- This type of costing method was developed when direct labour was a higher proportion of the costs and overheads were lower. Investment in machinery and services has reduced direct labour costs and simultaneously increased overhead costs but we still use the same old costing systems.
- Our efforts have not changed to reflect reality. The model we use is no longer valid.
- The older style cost accounting formulas are becoming even more inaccurate with time.

| Cost Category    | 1960 | 1986 | 1996 |
|------------------|------|------|------|
| Overheads        | 15%  | 30%  | 35%  |
| Direct Labour    | 25%  | 12%  | 10%  |
| Direct Materials | 60%  | 58%  | 55%  |

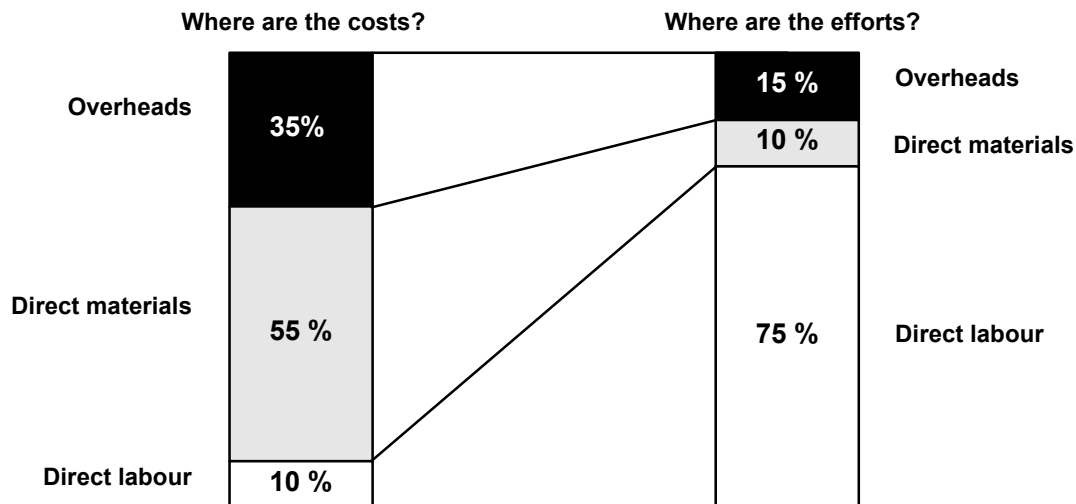
### The changes in the cost categories with time

Note: These figures may not be exactly right for your company but they won't be far out. The direct labour cost is much less than the overheads cost but we still use direct labour hours for cost allocations!

- Overhead costs are ripe for both change and management.

## 3. The management efforts

- Where do we currently allocate our efforts at cost reduction? The Work Study Department measures and controls direct labour, the Purchasing Department attempts to control direct materials purchases after the product has been designed and nobody controls the overhead costs.



### The efforts at cost management

#### 4. The biggest costs have the least efforts to reduce them - are we trying to get it wrong?

- Labour costs are only about 10% of the cost of the product but the largest amount of effort goes into reducing labour in the process - 75% of the effort is in reducing labour costs and only 15% in reducing overhead costs. Our efforts are incorrectly focused because we are using a model sends us in the wrong direction when trying to manage costs.
- Reducing overheads by 10% gives a product cost reduction of about 3.5% - the same as a labour cost reduction of 35%. To save money then start with the big numbers where the big savings are. Whatever happened to Pareto analysis? (see Easy Guide 6).
- Realistic cost management is trying to understand what we are really doing. Unrealistic costing distorts reality so that good profitable products are killed whilst unprofitable products are produced.

#### 5. What are the new rules?

- Cutting costs is not the same thing as becoming a low-cost producer.
- Cutting investment to reduce costs is a short-term measure.

***Managing costs can make you a low-cost producer, simply cutting them will not!***

#### 6. The ABC's of accurate costing

- Cost accounting should reflect our activities and the efforts we use to make the product. It should manage the result rather than simply inform upper management of what happened months ago.
- Example: A business has overhead costs of £50K per year and deals with two products, both of which have sales of £1,000K per year and which take exactly the same amount of materials and working hours. The only difference is in the sales pattern: Product A sells 10 orders of £100K per year to one customer and Product B sells 1,000 orders per year of £1000 to 100 different customers. Convention says that the costs are distributed equally between the products and both accept an overhead of £25K per year even though Product B uses at least 100 times as much transaction effort as Product A. Convention over-prices Product A and under-prices Product B.
- Activity Based Costing (ABC) assigns overhead costs (or transaction costs) in more accurate proportions to the products that require them. ABC says that activities drive the overhead costs and are a sounder basis for allocating costs than any of the current methods.
- ABC looks at the "cost drivers" and says that a global overhead figure from direct labour or machine hours cannot be used to work out product cost. The product cost is related to the activities necessary to get and produce the particular job (the "cost drivers"). ABC requires more analysis but gives clearer understanding of what a product really costs. Without ABC the "costs" used for pricing probably bear little relation to those that are actually incurred.
- ABC gives a clear allocation of overhead costs based on results and allows concentration on managing and reducing the transactions that drive the overheads and concentrate on results achieved - i.e. on effectiveness rather than efficiency.

***It is totally useless being efficient at something that you shouldn't be doing!***

#### 7. What are the overheads that we can manage?

- ABC is a tool to focus on how overheads are generated, their value for money and allows us to reduce or eliminate those that do not generate value. The Pareto Principle tells us that 80% of the results in our business will be created by 20% of the activities. To improve overhead productivity, we must focus on and improve the vital 20% and cut or remove the trivial 80%?

***To manage overheads managers first have to accept that these costs are under their control and that they are not simply there to be allocated away and disappear!***

***For some hints on what to do next see Easy Guide 3a. Overhead Costs "Hit List" - Things to do Next.***